Statement of
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In December 1995, The California Public Utility Commission issued an order making California the first state to mandate competitive restructuring in electric power. Less than four years later, 24 states, accounting for about 65 percent of the gross domestic product are scheduled to begin competition. (See Table 1). Competition has already started in four states – California, Massachusetts, Rhode Island and Pennsylvania – representing 20 percent of the economy.[1] (See Table 2).

In keeping with their role as "laboratories of democracy," the states have adopted differing approaches to electricity competition.[2] But, all share a common framework consisting of a competitive generation sector; a jointly owned, independently operated, but highly regulated transmission network; and locally regulated distribution companies that have exclusive service territories, as at present. The creation of a competitive generation sector is clearly for the good. The wires component of the emerging model is, however, questionable. In particular, a highly regulated transmission network has the potential to undermine the gains from a competitive generation market.

Price Caps and Shopping Credits

The introduction of retail access has produced price reductions for all classes of consumers, partly as a result of competition, and partly as a result of mandated price reductions. (See Table 3).

States have adopted pricing restrictions that are not typically characteristic of competition. The great majority of state plans, including the plans for the four states that have already opened their markets, include some form of price cap on electricity rates. Some states – e.g., Pennsylvania – have frozen rates at their existing levels, while others – e.g., California and Massachusetts – have mandated reductions. The value of the Pennsylvania and Massachusetts price cap "options" is estimated to be about 9 and 7 percent, respectively, of the present value of their market revenues.[3]

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[1] These are the states in which retail access is fully underway. In addition, competition has begun to be phased in in New York, Montana and New Hampshire, and is scheduled to start later this year in Illinois, Michigan and New Jersey.

[2] See Michael K. Block, *Deregulating Electricity: Progress in the States*, The Progress & Freedom Foundation, March 1998; and Michael K. Block and Thomas M. Lenard, *Deregulating Electricity: The Federal Role*, The Progress & Freedom Foundation, April 1998.

[3] Frank Graves and Paul Liu, "Price Caps for Standard Offer Service: A Hidden Stranded Cost," *The Electricity Journal*, December 1998.

The majority of states – again, including the four states where competition has started – have also instituted a "shopping credit" (also called a "standard offer" or "price to compare") as part of their retail access plans. Shopping credits determine the circumstances under which it is in the consumer's interest to switch suppliers. Where the shopping credit is relatively high, as it has been in Pennsylvania, the switching rate has been relatively high. In other states, such as Massachusetts and Rhode Island, both the shopping credit and switching rate have been relatively low. In these states, the switching rate is a function of an administratively determined price, which does not necessarily reflect underlying competitive conditions.

In California, in contrast, the shopping credit is determined by the PX price, which is a market-based price. Because of this – i.e., because it is difficult to beat the market-determined PX price – switching rates in California have been low.

On the surface, at least, there does not appear to be a close correlation between switching rates and price declines. Declines in California, for example, have been significant, while switching rates have been low.

Price caps and administratively determined shopping credits can be viewed as transitional devices, designed to assure that consumers enjoy some savings and that some competition develops during the transition period, while the IOUs are recovering their stranded costs. Whatever their merits in the short run, in the long run, they obviously are not consistent with the development of a competitive electricity sector.

Disadvantaging Incumbents

All of the state restructuring plans incorporate measures that reflect market power concerns. In some states, these concerns have produced provisions specifically designed to disadvantage incumbents. These provisions may also have the effect of disadvantaging consumers by preventing them from obtaining the lowest prices attainable. A number of states place restrictions on utility affiliates, some of them quite severe. California, for example, prohibits a utility from using its facilities – offices, capital and employees – jointly with an affiliate, thus effectively preventing the utilities, and their customers, from enjoying the benefits of economies of scope that may be present. Affiliate restrictions frequently also include limitations on the use of the utility's brand name by an affiliate, and a Pennsylvania proposal would outright prohibit affiliate use of a utility's brand name, thereby depriving consumers of a potentially important source of information.

Some states have gone even further. In Maine, concern about incumbent utilities has taken the form of a numerical limitation on the market share. Affiliates are limited to selling 33 percent of the total kilowatt hours sold within the service territory of their transmission and distribution affiliate.

Divestiture and Functional Separation

Most of the state plans require functional separation of generation from transmission, or even divestiture of generation plants. States that do not require divestiture often make it an attractive option, and a substantial amount of divestiture has taken place in the four retail-access states. In California, all three IOUs have divested all their non-nuclear generation facilities. In Massachusetts and Rhode Island, the major utilities, including NEES, EUA and Boston Edison, have done the same. In Pennsylvania, Duquesne Light and GPU are in the process of selling their power plants.

Divestiture and functional separation requirements are designed to address the concern that vertically integrated utilities (even if, as currently planned, their distribution and transmission networks remain regulated) might favor their own generation over lower-cost alternatives and, hence, frustrate competition. Apart from the vertical issues, some states are concerned that generation itself is likely to be highly concentrated in some markets. Divestiture requirements in California and New York appear at least partly aimed at this type of market power.

Independent System Operators and Regional Transmission Organizations

Because the principal legacy of regulation is an inefficient and costly stock of generating capital, the restructuring discussion has focused on introducing competition and efficient pricing in the generation sector. If, however, one of the principal goals is to rationalize the power industry's capital stock, then the structure and efficiency of transmission is also of critical importance, because the relationship between generation and transmission is a close one. Generation and transmission are complements, which together produce delivered electricity. But, they are also, increasingly, substitutes and this trend is likely to accelerate as competition develops.

Most of the states are either requiring or encouraging transmission owners to turn control of their networks over to an Independent System Operator (ISO). The Federal Energy Regulatory Commission (FERC) has also been promoting this concept.

The ISO framework is designed to constrain market power and ensure nondiscriminatory open access to transmission facilities. This is achieved by separating ownership of the transmission network from its operational control. As indicated above, however, most (if not all) states are already requiring functional unbundling and many IOUs have divested their generation facilities and become transmission-only companies. Moreover, at the federal level, FERC Orders 888/889 also are intended to address the open access issue.

The ISO framework – which has metamorphosed into the somewhat more flexible Regional Transmission Organization model – represents a risky regulatory

experiment.[4] Requiring asset owners to transfer operational control of their assets to third parties is rarely, if ever, done in our economic system. It has not, for example, been done for other major regulated industries, such as telephones, airlines, railroads and trucking.

In the ISO model, the ISO is supposed to be independent of all interests. No one really knows what incentive structure will guide the ISOs. But, neither empirical evidence nor theoretical analysis suggests that institutions designed like ISOs – i.e., in which ownership and operational control are separated – are likely to produce efficient pricing, usage or investment decisions. Indeed, we do not have any experience with institutions like ISOs. Both government ownership and economic regulation represent (different degrees of) separation of ownership from control, and our experience with neither of these institutions has been encouraging.

The ISO/RTO concept is fundamentally flawed because it approaches the regulation of transmission markets as if it were a series of engineering problems to be solved and ignores the critical role that institutions and incentives play in determining economic behavior. The states, together with federal regulators, are in the process of creating economic institutions with unknown incentive structures and unpredictable economic outcomes. What, for example, will be the incentives of an ISO/RTO when it comes to maintaining and expanding the grid? Will decisions be made on the basis of economic or political criteria?

There is no reason to believe we know how to operate a centralized regulatory system for the transmission network any better than the current regulatory system has been operated. The ISO has been presented as the ideal planning organization, with no economic interests or incentives except to run the transmission system and determine transmission prices and investments in the public interest. Since such organizations are few and far between, there is a large element of wishful thinking in believing that one is likely to appear now. As one commenter on restructuring issues has observed, in discussing the incentives facing ISOs, "if British experience is any guide, motherhood injunctions to 'be good' achieve little, and this issue will rapidly come to the fore."[5]

Conclusion

After the current transitional period is over, it will be desirable to simply eliminate barriers to entry, remove as many regulatory intrusions as possible and let the market go. In the generation market, regulatory prices of all kinds should be eliminated.

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[4] For a discussion of ISO/RTO issues, see Thomas Lenard, "Getting the Transcos Right," *The Electricity Journal*, November 1998; and Thomas M. Lenard, Comments on Regional Transmission Organizations Notice of Proposed Rulemaking, Federal Energy Regulatory Commission Docket No. PM99-2-000, August 19, 1999.

[5] Alex Henney, "Contrasts in Restructuring Wholesale Markets," *The Electricity Journal*, August/September 1998, p.33.

If the goal is to provide electricity (and perhaps other services) to consumers at the lowest cost – as it should be – regulators should also refrain from attempting to bias the market in favor of new entrants. Incumbents should not benefit from any artificial advantages, but they should also not incur the costs of artificial disadvantages.

Finally, both state and federal regulators should be especially concerned about the new regulatory layers they are adding for the transmission sector, without any evidence that they will produce desirable results.